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Supreme Court of the United States

October Term, 1973

No. 73-1137

AMERICAN FIDELITY FIRE INSURANCE COMPANY, a New York corporation,

Petitioner,

vs.

STATE BOARD OF EQUALIZATION OF THE STATE OF CALIFORNIA,

Respondent.

Petition for a Writ of Certiorari to the California Court of Appeals.

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IN THE

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AMERICAN FIDELITY FIRE INSURANCE COMPANY, a New York corporation,

Petitioner,

vs.

STATE BOARD OF EQUALIZATION OF THE STATE OF CALIFORNIA,

Respondent.

Petition for a Writ of Certiorari to the California Court of Appeals.

The Petitioner, American Fidelity Fire Insurance Company, prays that a Writ of Certiorari issue to review the Opinion and Judgment of the California Court of Appeals rendered in these proceedings on October 24, 1973.

Opinions Below.

The opinion of the Superior Court, State of California, Superior Court of Los Angeles County, Book 6703, page 362, not reported, appears at Appendix "A", *infra,* pages 1-8. The Opinion of the California Court of Appeals, 34 Cal.App.3d 52, 109 Cal.Rptr. 545, (1973), appears at Appendix "B", *infra,* pages 9-15. The Supreme Court of the State of California

issued no opinion in denying the Petition for Hearing, and the Order denying such petition appears at Appendix "C", *infra,* page 16.

Jurisdiction.

The Judgment of the California Court of Appeals was entered on August 27, 1973. The Order of the Supreme Court of the State of California denying the Petition for Hearing was entered on October 24, 1973. This Petition for Certiorari was filed less than ninety (90) days from the date of denial of the Petition for Hearing. The jurisdiction of this Honorable Court rests upon 28 U.S. Code §1257(3).

Questions Presented.

Petitioners herein brought suit in the Superior Court for the County of Los Angeles, State of California, against the California State Board of Equalization seeking a declaration that the method whereby California Revenue and Tax Code Penalty provisions were summarily applied to Petitioner, were wrongful. The questions thereby arising are:

1. Whether Amendment V and Amendment XIV to the Constitution of the United States require that a State, prior to assessing tax penalties, against a taxpayer's surety for the default of the taxpayer, must give notice to the surety of the amount due before assessing additional sums in the form of penalties against the taxpayer's surety.

2. Whether the assessment of tax penalties against the taxpayer may be imputed to the surety absent notice of the impending default of the principal to the surety.

Constitutional Provisions Involved.

Fifth Amendment to the Constitution of the United States:

> "No person shall be held to answer for a capital, or otherwise infamous crime, unless on a presentment of indictment of a Grand Jury, except in cases arising in the land or naval forces, or in the Militia, when in actual service in time of War or public danger, nor shall any person be subject for the same offence to be twice put in jeopardy of life or limb; nor shall be compelled in any criminal case to be a witness against himself, nor be deprived of life, liberty, or property, without due process of law; nor shall private property be taken for public use, without just compensation."

Fourteenth Amendment to the Constitution of the United States, Section 1:

> "All persons born or naturalized in the United States, and subject to the jurisdiction thereof, are citizens of the United States and of the State wherein they reside. No State shall make or enforce any law which shall abridge the privileges or immunities of citizens of the United States; nor shall any State deprive any person of life, liberty, or property, without due process of law; nor deny to any person within its jurisdiction the equal protection of the laws."

California Statutory Provisions Involved.

California Revenue and Taxation Code, §6701:

> "*Authority to require; amount; increase or decrease; notice and sale, auction, private sale; surplus.*

The board, whenever it deems it necessary to insure compliance with this part, may require any person subject thereto, to place with it such security as the board may determine. The amount of the security shall be fixed by the board but, except as noted below, shall not be greater than twice the estimated average liability of persons filing returns for quarterly periods or three times the estimates average liability of persons required to file returns for monthly periods, determined in such manner as the board deems proper, or ten thousand dollars ($10,000), whichever amount is the lesser. In case of a person who, pursuant to Section 6070 of this part, has been given notice of hearing to show cause why his permit or permits should not be revoked, or a person whose permit or permits has been revoked or suspended, the amount of the security shall not be greater than three times the average liability of persons filing returns for quarterly periods or five times the average liability of persons required to file returns for monthly periods, or ten thousand dollars ($10,000), whichever amount is the lesser. The limitations herein provided apply regardless of the type of security placed with the board. The amount of the security may be increased or decreased by the board subject to the limitations herein provided. The board may sell the security at public auction if it becomes necessary so to do in order to recover any tax or any amount required to be collected, interest or penalty due. Notice of the sale may be served upon the person who placed the security personally or by mail; if by mail, service shall be made in the manner prescribed

for service of a notice of a deficiency determination and shall be addressed to the person at his address as it appears in the records of the board. Security in the form of a bearer bond issued by the United States or the State of California which has a prevailing market price may, however, be sold by the board at private sale at a price not lower than the prevailing market price thereof. Upon any sale any surplus above the amounts due shall be returned to the person who placed the security.

(Added by Stats. 1941, c. 36, p. 548, §1. Amended by Stats. 1941, c. 247, p. 1350, §36; Stats. 1945, c. 926, p. 1725, §4.5, eff. June 15, 1945, operative July 1, 1945; Stats. 1947, c. 567, p. 1557, §6, eff. June 5, 1947, operative July 1, 1947; Stats. 1955, c. 833, p. 1450, §1.)"

California Revenue and Taxation Code, §6484:

"Penalty, negligence or intentional disregard of law, rules or regulations.

If any part of the deficiency for which a deficiency determination is made is due to negligence or intentional disregard of this part or authorized rules and regulations, a penalty of 10 per cent of the amount of the determination shall be added thereto. (Added by Stats. 1941, c. 36, p. 545, §1.)"

California Revenue and Taxation Code, §6485:

"Penalty; fraud; intent to evade.

If any part of the deficiency for which a deficiency determination is made is due to fraud or an intent to evade this part or authorized rules and regulations, a penalty of 25 per cent of the amount

of the determination shall be added thereto. (Added by Stats. 1941, c. 36, p. 545, §1.)"

California Revenue and Taxation Code, §6561:

"*Petition; time; finality of determination upon failure to file.*

Any person against whom a determination is made under Articles 2 or 3 of this chapter or any person directly interested may petition for a redetermination within 30 days after service upon the person of notice thereof. If a petition for redetermination is not filed within the 30-day period the determination becomes final at the expiration of the period. (Added by Stats. 1941, c. 36, p. 547, §1. Amended by Stats. 1941, c. 247, p. 1350, §35.)"

California Revenue and Taxation Code, §6562:

"*Reconsideration; hearing; notice; continuances.*

If a petition for redetermination is filed within the 30-day period, the board shall reconsider the determination and, if the person has so requested in his petition, shall grant the person an oral hearing and shall give him 10 days' notice of the time and place of the hearing. The board may continue the hearing from time to time as may be necessary. (Added by Stats. 1941, c. 36, p. 547, §1.)"

California Revenue and Taxation Code, §6564:

"*Finality of redetermination.*

The order or decision of the board upon a petition for redetermination becomes final 30 days after service upon the petitioner of notice thereof. (Added by Stats. 1941, c. 36, p. 547, §1.)"

California Revenue and Taxation Code, §6591:

"*Nonpayment of tax.*

Any person who fails to pay any tax to the State or any amount of tax required to be collected and paid to the State, except amounts of determinations made by the board under Articles 2 or 3 of this chapter, within the time required shall pay a penalty of 10 per cent of the tax or amount of the tax, in addition to the tax or amount of tax, plus interest at the rate of one-half of 1 per cent per month, or fraction thereof, from the date on which the tax or the amount of tax required to be collected became due and payable to the State until the date of payment. (Added by Stats. 1941, c. 36, p. 547, §1)."

Statement of Facts.

The stipulated facts relevant to the questions presented by this Petition are summarized below, with the full text thereof set forth in Appendix "D", pages 17-19.

(a) American Fidelity Fire Insurance Company is a New York corporation, licensed to do and doing surety business in the State of California. The State Board of Equalization is an agency of the State of California, charged with administration, collection, and enforcement of California sales and revenue tax provisions.

(b) American Fidelity Fire Insurance Company, for consideration, executed surety bonds pursuant to the provisions of California Revenue and Taxation Code, Section 6701.

(c) After notice of default on the part of certain of its taxpayers, Petitioner paid to the State Board of Equalization those amounts of principal plus interest claimed to be due, but did not pay all penalties.

(d) On February 16, 1970, Petitioner filed a claim with the California Board of Control. On March 19, 1970, said claim was denied by that Board. Appendix "E", page 20.

(e) On March 24, 1970, Petitioner filed a Complaint for Declaratory Relief, for an Accounting and for Money against the State Board of Equalization. The First Cause of Action is reprinted as Appendix "F", pages 21-25, as a typical claim therefrom.

(f) On January 19, 1972, a Judgment was entered by the Honorable Robert W. Kenney, Superior Court for Los Angeles County, denying Petitioner's claim therein and granting the State Board of Equalization judgment on its cross-complaint for the unpaid penalty amounts. Appendix "A", pages 1-2.

(g) Thereafter, Petitioner appealed the Rulings of the Superior Court. In an Opinion entered August 27, 1973, the California Court of Appeals affirmed the Judgment below. Appendix "B", pages 9, 15.

(h) Thereafter, Petitioner filed a Petition for Hearing to the California State Supreme Court. That Hearing was denied on October 24, 1973. Appendix "C", page 16.

Federal Questions.

Petitioner herein has asserted throughout the progress of this litigation that the summary fashion in which the penalty provisions of the California Revenue and Taxation Code were applied to the taxpayer's surety are unconstitutional inasmuch as they constitute an economic forfeiture without notice. That was the basis of the claim submitted to the Board of Control. Allegations of unconstitutionality with regard to a denial of due process were an integral part of the initial Complaint in the Superior Court. See Appendix "F", pages 23-25. These issues were further briefed and argued on appeal. See Appendices "G" and "H", pages 26-28 and pages 29-30. In the Petition for Hearing to the California State Supreme Court, the constitutional challenge was maintained.

In the Judgment of the Superior Court, entered January 19, 1972, Book 6703, page 362, Superior Court of Los Angeles County, the Findings of Fact and Law specifically held the challenged tax provisions, as applied to taxpayer's surety, to be constitutional. See Appendix "A", page 7. The California Court of Appeals, in affirming the Judgment of the Superior Court, held that the California Revenue and Taxation Code provisions, despite lack of notice to the surety, were constitutionally sufficient. Appendix "B", pages 13-14.

Petitioner then attempted to secure the resolution of this question in the highest court of the State of California. The basis of that Petition was that the California Court of Appeals had failed to properly resolve the due process issues and constitutional questions. See Appendix "I", page 31.

REASONS FOR GRANTING THE WRIT.

The Decision of the California Court of Appeals Directly Conflicts With Principles of Procedural Due Process as Enunciated by This Court.

1. As a condition of doing business, the State of California requires a bond as security for taxes. If the California State Board of Equalization decides the taxpayer owes additional taxes, a determination thereof is sent the taxpayer. Unless the taxpayer formally contests the determination, it becomes final 30 days after service. At that time, statutory penalties, which are the subject of these proceedings, accrue. Prior to expiration of the 30-day period, no notice of default or demand for taxes and interest is sent the taxpayer's surety.

The running of the 30 days then establishes the incontestable "validity" of the penalty. If the taxes and interest were timely paid, the penalty provisions would be inapplicable. It is the lack of notice to the taxpayer's surety which prevents the surety from timely payment, an option known only to the taxpayer. While it is true that the surety is engaged in commercial activity, there should be no question that even a commercial entity is entitled to notice of impending extra tax penalties according to constitutionally acceptable processes.

Clear criteria have been established by which the fairness and adequacy, with respect to procedural due process, of summary state procedures whereby vested rights may be taken, should be evaluated. In *Sniadach v. Family Finance Corporation* (1969), 395 U.S. 337, a due process challenge to state summary wage garnishment procedures resulted in those procedures being stricken down. That case established that due process

required notice and an opportunity to be heard prior to the taking. In his concurring opinion, Mr. Justice Harlan explained:

> "I think that due process is afforded only by the kinds of notice and hearing which are aimed at establishing the validity, or at least the probable validity, of the underlying claim against the alleged debtor before he can be deprived of his property or its unrestricted use." *Sniadach,* at page 343.

2. It should be no less a constitutional requirement that notice of the matured tax obligation and impending penalty assessment, be given to the obligor before he may be penalized for his failure to meet that obligation. Such notice has been consistently held by this Court to be a rigid requirement of due process. In *Lambert v. State of California,* 335 U.S. 225, this Court stated:

> "There is a wide latitude in the lawmakers to declare an offense and to exclude its elements of knowledge and diligence from its definition. See *Chicago B & O Railway Company v. United States,* 220 U.S. 559, 578, 31 S.Ct. 612, 617, 55 L.Ed. 582. But we deal here with conduct that is wholly passive—mere failure to register. It is unlike the commission of acts or the failure to act under circumstances that should alert the doer to the consequences of his deed. (citations omitted). The rule that 'ignorance of the law will not excuse' . . . is deep in our law as is the principle that of all the powers of local government, the police power is 'one of the least limitable.' *District of*

> *Columbia v. Brooke*, 214 U.S. 138, 149, 29 S.Ct. 560, 563, 53 L.Ed. 914. On the other hand, due process places some limits on its exercise. Ingrained in our concept of due process is the requirement of notice. Notice is sometimes essential so that the citizen has the chance to defend charges. Notice is required before property interests are disturbed, before assessments are made, *before penalties are assessed. Notice is required in a myriad of situations where a penalty or forfeiture might be suffered for mere failure to act.* Recent cases illustrating the point are *Mullane v. Central Hanover Bank & Trust Company*, 339 U.S. 306, 70 S.Ct. 652, 94 L.Ed. 865; *Covey v. Town of Summers*, 351 U.S. 141, 76 S.Ct. 724, 100 L.Ed. 1021; *Walker v. City of Hutchison*, 352 U.S. 112, 77 S.Ct. 200, 1 L.Ed.2d 178." *Lambert* at page 228. (Emphasis added).

Since the surety is not given notice of the fact that its taxpayer has failed to pay his taxes and is about to be charged with a penalty, there appears a *prima facie* failure of due process.

3. The procedures adopted are not only constitutionally defective, but exhibit a basic unfairness, as applied, because the penalty assessments are applied after the default of the taxpayer over whom Petitioner has no control. The finding of the California Court of Appeals that Petitioner could require notice from the taxpayer does not properly meet the burden of the State with respect to due process. It is the State, not the taxpayer, which is involved in the actual taking. Decisions of this Court have stressed the necessity for basic fair-

ness. Mr. Justice Stewart, speaking for this Court, in *Fuentes v. Chevin,* (1972) 407 U.S. 67, noted:

> "The purpose of 'the Constitutional right to be heard' is not only to ensure abstract fair play to the individual. Its purpose more particularly, is to protect his use and possession of property from arbitrary encroachment—to minimize substantially unfair or mistaken deprivation of property." *Fuentes,* at page 80.

Thus, this basic unfairness with respect to lack of actual notice (and opportunity to be heard) before a taking by the State, from the taxpayer's surety, based on the independent actions of the taxpayer, requires close scrutiny.

4. The decision of the California Court of Appeals further shielded itself in its finding of constitutionality by reliance upon the historic needs of the sovereign for tax revenues. Historic doctrines should not be permitted to be used by a State as a shelter for wrongful action. Even in the case of taxes, which historic policy has permitted the sovereign to collect in a summary fashion, as a necessity for the financing of the on-going functions of government, there is no reasonable basis for exempting a State from basic due process requirements. This Court has, in the past, explicitly rejected such an approach:

> "The Court rejected the argument that the need to protect the public's tax revenue supplied the requisite 'overwhelming consideration'." Mr. Justice Brennan, *Goldberg v. Kelly,* (1970) 397 U.S. 254, at page 261.

And in another decision elucidating the need for procedural due process, *Stanley v. Illinois,* (1972) 405

U.S. 645, Mr. Justice White, speaking for the Court, said:

> "But we are here not asked to evaluate the legitimacy of State ends, but, rather, to determine whether the means used to achieve these ends are constitutionally defensable." *Stanley*, at page 652.
>
> "But the Constitution recognizes higher values than speed and efficiency." *Stanley*, at page 656.

Based on the above language, the decision of the California Court of Appeals is not in conformity with the decisions of this Court. The entire surety and insurance industry of the State of California is subject to this summary process, and therefore deprived of their right to notice of the impending penalty assessment. Since these assessments are applied after passive conduct, arising from lack of knowledge *which due diligence cannot cure*, and since resolution of this question has been sought and denied before the highest Court of the State of California, this Court should consider the due process questions raised herein.

Conclusion.

For these reasons, a Writ of Certiorari should issue to review the judgment and opinion of the California Court of Appeals.

Respectfully submitted,

BARRY BERNSTEIN,
Attorney for Petitioner.

APPENDIX A.

Judgment.

Superior Court of the State of California, for the County of Los Angeles.

American Fidelity Fire Insurance Company, a New York corporation, on behalf of itself and all others similarly situated, Plaintiffs, v. State Board of Equalization and Does I through XXV, inclusive, Defendants.

State Board of Equalization of the State of California, Cross-Complainant, v. American Fidelity Fire Insurance Company, a New York corporation, Cross-Defendant. No. 973505.

Filed: Jan. 19, 1972.

The above-entitled causes came on regularly for trial on November 8, 1971, in Department 68 of the above-entitled court, the Honorable Robert W. Kenny, Judge Presiding, without a jury, a jury having been expressly waived. Plaintiffs and cross-defendant were represented by their attorney Barry Bernstein and defendant and cross-complainant State Board of Equalization of the State of California appeared by its attorney Evelle J. Younger, Attorney General, by Philip C. Griffin, Deputy Attorney General.

Said causes having been heard on a stipulation of facts and said causes having been submitted for a decision, the court having rendered its decision in favor of defendant State Board of Equalization and for said board as cross-complainant against cross-defendant American Fidelity Fire Insurance Company and the board, and the court having made, signed and filed its findings of fact and conclusions of law,

IT IS ORDERED, ADJUDGED AND DECREED that:

1. Plaintiff recover nothing by virtue of plaintiffs' complaint on file herein, and

2. That cross-complainant recover $11,005.54, the total sum of the amounts set forth in Exhibit "B" of the cross-complaint plus $1,013.75 interest computed in at the rate of ½ percent per month from the date of demand and notice to date of judgment as to each individual bond obligation, and costs of suit in the amount of $13.00.

Dated: Jan. 19, 1972

/s/ Robert W. Kenny
Judge of the Superior Court

Proposed Findings of Fact and Conclusions of Law.

Superior Court of the State of California, for the County of Los Angeles.

American Fidelity Fire Insurance Company, a New York corporation, on behalf of itself and all others similarly situated, Plaintiffs, v. State Board of Equalization, and Does I through XXV, inclusive, Defendants.

State Board of Equalization of the State of California, Cross-Complainant, v. American Fidelity Fire Insurance Company, a New York corporation, Cross-Defendant. No. 973505.

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Said causes having been heard on a stipulation of facts and said causes having been submitted for a decision, the court having rendered its decision in favor of defendant and cross-complainant against the plaintiff and cross-defendant, now makes the following findings of fact and conclusions of law:

FINDINGS OF FACT

The court finds that:

I

The facts set forth in the stipulation of facts and the agreed and admitted matters in the joint pretrial statement are true, and the court incorporates those facts by reference in these findings of fact.

II

The first cause of action of the complaint is not one of common and general interest to all insurance companies duly licensed to do business and doing business in the State of California of writing surety bonds pursuant to the Revenue and Taxation Code of the State of California. Such other insurance companies do not comprise a class so numerous that it is impractical for all to appear before a superior court as individual plaintiffs, and, therefore, plaintiff American Fidelity Fire Insurance Company cannot bring suit for itself on behalf of and for the benefit of other insurance companies.

III

American Fidelity Fire Insurance Company has for consideration recited thereon written surety bonds in the form attached to the answer as Exhibit "A" pursuant to section 6701 of the Revenue and Taxation Code, and no other sections of that code. No other insurance companies are similarly situated in writing surety bonds pursuant to the Revenue and Taxation Code.

IV

Plaintiff American Fidelity Fire Insurance Company has not been paid all penalties due pursuant to the Revenue and Taxation Code.

V

The board does not require and demand that American Fidelity pay all penalties of their numerous principals pursuant to surety bond without notice to American Fidelity of the default by their principals. It is not true that liability to pay penalties can arise only after proper demand and notice, and such is not the intent of section 2808 of the Civil Code. American Fidelity is not unable, by the exercise of reasonable diligence, to acquire information of any default by their numerous principals.

VI

No amount of money in penalties was improperly collected by the board from American Fidelity.

VII

No actual controversy has arisen, nor does one exist between American Fidelity and the board.

VIII

American Fidelity has not exhausted all administrative remedies and irreparable injury will not result to American Fidelity unless a declaration of its rights is made.

IX

American Fidelity and the board have not been conducting themselves under a mutual mistake of law with respect to notice of default, and, therefore, American Fidelity has not been deprived of an opportunity to be heard and to cure.

X

The board does not compel American Fidelity to insure and thus relieve principals of the penal conse-

quences and liabilities which flow as a result of their intentional wilful, wrongful, and unlawful nonpayment of amounts rightfully due to the board.

XI

The Revenue and Taxation Code provisions do not insure principals against the penal consequences of their intentional, wilful, wrongful and unlawful conduct and the provisions of section 2773 of the Civil Code are not violated by the Revenue and Taxation Code.

XII

American Fidelity is not entitled to any relief in this action.

XIII

There is now due owing and unpaid from American Fidelity to the board on each respective bond the amount set forth in Exhibit "B" under the heading of "Delinquency" together with interest thereon at the rate of ½ percent per month from the date of demand and costs.

XIV

Any finding of fact herein contained that may be construed as a conclusion of law may be deemed to be a conclusion of law, and any conclusion of law herein contained that may be construed to be a finding of fact may be deemed to be a finding of fact.

From the foregoing facts, the court concludes:

CONCLUSIONS OF LAW

I

The complaint fails to state facts sufficient to constitute a cause of action in any of the causes of action set forth therein.

II

There is no jurisdiction for an action for declaratory relief or an accounting to American Fidelity.

III

There is a defect and misjoinder of parties plaintiff and the action is not a proper class action.

IV

California Revenue and Taxation Code is constitutional in imposing liability on a surety for the payment of penalties on a bond and does not require demand or notice nor does it delegate a state penal duty.

V

Section 2773 of the Civil Code is inapplicable under the specific provisions of the California Revenue and Taxation Code with regard to bonds.

VI

American Fidelity is not entitled to refund for the penalties properly collected under the terms and provisions of the bonding agreement and in addition American Fidelity must pay the penalties which it has illegally withheld from the state.

VII

The board is entitled to have judgment against American Fidelity for the total sum of the amount set forth in Exhibit "B" of the cross-complaint in the column headed "Deficiency" plus interest at ½ percent per month from the date of demand as to each bond until judgment is entered, together with the cause (sic) of this suit.

Let judgment be entered accordingly.

Dated: Jan. 19, 1972

/s/ Robert W. Kenny
Judge of the Superior Court

APPENDIX B.

Opinion of the Court of Appeal.

In the Court of Appeal of the State of California, Second Appellate District, Division Four.

American Fidelity Fire Insurance Company, a New York corporation, Plaintiff, Cross-Defendant and Appellant, vs. State Board of Equalization of the State of California, Defendant, Cross-Complainant and Respondent. Civ. No. 40797, Sup. Ct. #973505.

Filed: Aug. 27, 1973.

APPEAL from a judgment of the Superior Court of Los Angeles County. Robert W. Kenny, Judge, Affirmed.

Barry Bernstein, for Plaintiff, Cross-Defendant and Appellant.

Evelle J. Younger, Attorney General, and Philip C. Griffin, Deputy Attorney General, for Defendant, Cross-Complainant and Respondent.

Plaintiff American Fidelity Fire Insurance Company, a New York corporation, brought this purported class action, on behalf of itself and "all others similarly situated," against the State Board of Equalization for declaratory relief, for an accounting, and for the refund of certain sums paid to the State of California within four years preceding the filing of the complaint. The Board filed a cross-complaint against the plaintiff, alleging that plaintiff owed taxes to the Board. The parties proceeded to trial by the court after filing a joint statement of issues and a stipulation of facts. The trial court made findings of fact and conclusions of law, and gave judgment to the Board on the complaint and cross-complaint. Plaintiff has appealed.

The stipulated facts show: plaintiff is a duly licensed insurance company engaged in the insurance business in California; the Board of Equalization is the state agency charged with the administration of the California Sales and Use Tax Law [contained in the Revenue and Taxation Code, Division 2, Part 1, §§ 6001, 7176] and local ordinances and enactments. Other facts mentioned herein also were established by stipulation. Plaintiff will sometimes be refered to herein as American Fidelity or the surety; the State Board of Equalization as the Board; and, unless otherwise specified, reference to code sections will refer to sections of the Revenue and Taxation Code.

This dispute centers around those sections of the Revenue and Taxation Code, and pursuant rules and regulations of the Board, which are applicable to the collection of delinquent sales and use taxes, including penalty assessments, owed to the state by retailers, persons required to pay sales and use taxes.[1] The California sales tax is an excise tax levied for the privilege of conducting a retail business in California. The sales tax is determined by the retailer's gross receipts from sales. The use tax is applicable to tangible personal property purchased for use in California. (See 43 Cal. Jur.2d, "Sales and Use Taxes," § 8, § 33, pp. 343, 382.) The Revenue and Taxation Code requires retailers to put up bonds to ensure the payment of sales and use taxes. Section 6701 specifically provides that "The [B]oard, whenever it deems it necessary to insure

[1]Plaintiff asserts, in its opening brief, that it is mounting an attack on 27 penalty provisions contained in the Revenue and Taxation Code; while there are provisions in the Code for the payment of penalties in connection with the motor vehicle fuel license and use fuel taxes, and the alcoholic beverage tax, the suit before us concerns sales and use tax penalties.

compliance with this part [of the Code], may require any person subject thereto, to place with it such security as the [B]oard may determine. . . ." The bonds required are written on a standard form acceptable to the state.

Plaintiff executes surety bonds in California guaranteeing the payment of use and sales taxes due from those persons primarily liable for the taxes, the retailers. It charges a premium for writing the bond.

Section 6484 provides that "If any part of the deficiency for which a deficiency determination is made [by the Board, when nonpayment occurs] is due to negligence or intentional disregard of this part or authorized rules and regulations, a penalty of 10 percent of the amount of the determination shall be added thereto." Section 6485 provides for the assessment of a penalty of 25 per cent, if fraud or an intent to evade by the taxpayer is found. Penalties in exact but varying percentages are provided for late prepayment (§§ 6476, 6477, 6478), late payment (§ 6591), failure to file a return (§ 6511) or fraudulent failure to file a return (§ 6514). Penalties may be avoided if the Board determines that a taxpayer's failure to make a timely return or payment is due to a reasonable cause and circumstances beyond the person's control, occurring notwithstanding the exercise of ordinary care and in the absence of willful neglect. (§ 6592). The Board issues a thirty-day delinquency notice to the taxpayer, and payments made prior to the expiration of that period are accepted without penalty. Notice and hearing requirements concerning determinations, delinquencies and penalties are set forth in sections 6561-6566.

Plaintiff American Fidelity executed a number of the bonds required by section 6701 before February

16, 1970. The bonds were identical in form, except that the particular circumstances of each bond (*i.e.*, the principal, the amount, the date, the number and the premium) differed. Some of the principals defaulted in the payment of sales and use taxes. The surety paid the principal, interest and the penalties determined to be due on the bonds where default occurred but for some months prior to February 1970, refused to pay the penalty assessments on the bonds of defaulting taxpayers, on the ground that while it did owe the principal and interest on the bonds, the penalty assessments were unconstitutional. On February 16, 1970, American Fidelity filed a claim on behalf of itself and others similarly situated with the Board of Control, (as provided in Gov. Code § 905.2) against the State of California, for the refund of amounts it had paid as penalties on section 6701 bonds within the last year. On March 17, 1970, the Board of Control denied the claim. The present action was filed March 24, 1970, plaintiff alleging that it was a class action, and setting forth six causes of action against the Board.

Since the facts established by the court's findings do not entitle plaintiff to prevail on any theory, it is unnecessary to pass upon various procedural issues argued in the briefs.

Plaintiff concedes that, pursuant to its contract with its principal, it is obligated absolutely to pay tax deficiencies incurred by its principal. It has no objection to payment of principal and interest; its objection is to the additional amounts that are assessed as penalties. Plaintiff contends, as to the penalties, that its right to due process of law is violated by a system which imposes

liability for penalties upon the surety without advance notice to the surety. The plaintiff argues that if notice were given to the surety upon default, it could act to make payment of principal on behalf of the taxpayer within the thirty-day grace period, and avoid the penalty.

Due process, as it has evolved with respect to taxes, has been described in the following terms:

> "It may be stated as a general rule that the due process clause of the federal Constitution is satisfied in matters of taxation if, at some stage before a tax becomes irrevocably fixed the *taxpayer* is given the right, of which he shall have notice, to contest the validity or amount of the tax before a board or tribunal provided for that purpose. [Citations.]" (*People v. Sonleitner,* 185 Cal.App.2d 350, 356.) (Italics added.)

The Revenue and Taxation Code does provide for notice and hearing with respect to the taxpayer of sales and use taxes. (§§ 6561-6566.) It does not require that notice be given to the surety. It has been held that notice and hearing to the taxpayer is not constitutionally compelled when the tax is self-assessed, as are income and sales taxes. (*Greene v. Franchise Tax Board,* 27 Cal.App.3d 38, 43.) Plaintiff undertakes, for a consideration which is a substantial percentage of the bond, to guarantee the payments due the state. In each case included in the factual stipulation, the amount of the bond written exceeded the total liability incurred by the taxpayer, including principal, interest and penalties. Thus, lack of notice did not result in the surety being required to pay more than it had originally obligated itself to pay. We agree with the trial court that there is no constitutional compulsion for the Board to

give duplicate notice to the surety; its obligation is fulfilled by notice to the taxpayer of the delinquency.

Plaintiff further claims that notice to the surety is required by Civil Code section 2808.[2] The trial court found that the surety could acquire information concerning the default, *i.e.*, by requiring such from the principal, and Civil Code 2808 did not apply to plaintiff's situation. We agree.

Plaintiff's next contention in support of its suit for refund is that the Board, by requiring plaintiff to pay penalties which it in turn collected from its principal, was engaging in a process characterized by the plaintiff as an unconstitutional delegation of police power to the private entity, the surety, by the state. Plaintiff cites no authority for this proposition, and we regard the argument as without merit. There is no delegation of police power inherent in a situation where a surety undertakes to pay tax delinquencies assessed by the taxing power against the principal.

Plaintiff further contends that the Board acts in violation of Civil Code section 2773 when it requires section 6701 bonds to be written so as to include the payment of penalty assessments in addition to principal and interest. Section 2773 provides that "An agreement to indemnify a person against an act thereafter to be

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[2]Civil Code section 2807 provides: "A surety who has assumed liability for payment or performance is liable to the creditor immediately upon the default of the principal, and *without demand or notice.*" (Italics added.)

Civil Code section 2808, upon which plaintiff relies, states: "Where one assumes liability as surety upon a conditional obligation, his liability is commensurate with that of the principal, and he is not entitled to notice of the default of the principal, unless he is unable, by the exercise of reasonable diligence, to acquire information of such default, and the creditor has actual notice thereof."

done is void if the act be known by such person at the time of doing it to be unlawful." That section prohibits an agreement to indemnify the wrongdoer. The bonds issued by plaintiff are to indemnify the state. The wrongdoer remains liable to the bonding company for whatever the latter has been compelled to pay on his behalf. Section 2773 has no application here.

Plaintiff argues that the taxing system, imposing penalties, is unreasonable; serves no useful purpose, punishes the surety rather than the actual wrongdoer, the defaulting taxpayer; and compels the surety to participate in an illegal contract. We find no merit in these contentions. The bonding requirement is a reasonable method of securing payment of revenue to the state. So, too, are the penalty provisions, the major purpose of which is to insure payment of taxes to the state, rather than to punish individual taxpayers or their sureties, who are not compelled to write bonds but do so for remuneration. Consideration of prompt payment is unusually present in the taxing situation when assurance is sought that revenue will be received in timely fashion from small business establishments, such as those whose bonds were the subject of this action by the plaintiff.

We conclude that the trial court correctly gave judgment to the Board on both plaintiff's complaint and upon the Board's cross-complaint.

The judgment is affirmed.

CERTIFIED FOR PUBLICATION

Jefferson, *J.*

We concur:

Files, *P. J.*

Dunn, *J.*

APPENDIX C.

Clerk's Office, Supreme Court, 4250 State Building.
San Francisco, California 94102
Oct. 24, 1973.

I have this day filed Order HEARING DENIED.

In re: 2 Civ. *No.* 40797 American Fidelity Fire Ins. *vs.* State Bd. of Equalization

Respectfully,

G. E. BISHEL
Clerk

APPENDIX D.

Stipulation of Facts.

Superior Court of the State of California, for the County of Los Angeles.

American Fidelity Fire Insurance Company, Cross-Defendants and Plaintiffs, v. State Board of Equalization, et al., Cross-Complainants and Defendants. No. 973505.

Filed: Oct. 6, 1971.

Plaintiff, American Fidelity Fire Insurance Company, hereinafter sometimes called "American Fidelity," is a New York corporation, licensed to do and doing insurance business in the State of California. Defendant, State Board of Equalization, hereinafter referred to as "the board," is an agency of the State of California charged with the administration and enforcement of the California Sales and Use Tax Law and local ordinances and acts in conformity therewith.

American Fidelity for consideration executed surety bonds pursuant to section 6701 of the Revenue and Taxation Code. A true copy of one such bond in the state required form is attached to the answer and the cross-complaint of the board and is incorporated by reference as if set forth in full at this point. American Fidelity executed an identical bond for each of the principals of the surety bonds executed pursuant to said section and each of the principals named in the cross-complaint of the board, with only the names of the principals, the amounts of the bond, the amounts

of the premium, the bond numbers and the dates differing. American Fidelity has paid the principal amounts due plus interest, but not all penalties in accordance with the surety bonds written by American Fidelity pursuant to section 5701 of the Revenue and Taxation Code.

On February 16, 1970, American Fidelity filed a claim against the State of California with the Board of Control pursuant to Government Code section 905.2. A copy of the claim is attached to the stipulation as Exhibit 1 and incorporated by reference as though fully set forth. The specific accounts enumerated in the Exhibit A to the claim were analyzed as to the basis for the penalty such as late payments of tax, failure to file returns, and negligence in computing taxes and specifically set forth in Exhibit 2 attached to this stipulation and incorporated by reference as though fully set forth. On March 19, 1970, American Fidelity was notified that its claim had been denied by the State Board of Control at its meeting of March 17, 1970. A copy of the notice is attached to this stipulation as Exhibit 3 and incorporated by reference as though fully set forth.

There is a complete list attached to the cross-complaint marked Exhibit B showing the numbers and amounts of the bonds, the names and sales tax accounts of the bond principals, the amount of delinquency, the amounts demanded from American Fidelity, the amounts paid, and the amounts of the demands remaining unpaid. The board has made a timely demand as set forth in Exhibit B of the cross-complaint.

American Fidelity has failed and refused to pay the amounts in the column headed "delinquency" in Exhibit B of the cross-complaint, which exhibit is incorporated by reference in this stipulation as though fully set forth herein.

DATED: 10-6-71.

EVELLE J. YOUNGER, Attorney General
PHILIP C. GRIFFIN,
Deputy Attorney General
By /s/ Philip C. Griffin,
PHILIP C. GRIFFIN,
Deputy Attorney General
Attorneys for Defendant,
State Board of Equalization

DATED: 10-6-71

By /s/ Barry Bernstein
BARRY BERNSTEIN
Attorneys for Plaintiff,
American Fidelity Fire Insurance Company

APPENDIX E.

March 19, 1970

Mr. Barry Bernstein
Attorney at Law
8500 Wilshire Boulevard, Suite 521
Beverly Hills, California 90211

Re: Claim of AMERICAN FIDELITY FIRE INSURANCE CO. v. State of California—No. 29877

Dear Mr. Bernstein:

The State Board of Control, at its meeting of March 17, 1970, denied the above entitled claim.

Very truly yours,

E. F. Veglia, Secretary
State Board of Control

EFV: im
cc: Board of Equalization

APPENDIX F.

Complaint for Declaratory Relief for an Accounting and for Money.

Superior Court of the State of California, for the County of Los Angeles.

American Fidelity Fire Insurance Company, a New York corporation, on behalf of itself and all others similarly situated, Plaintiffs, vs. State Board of Equalization, and Does I through XXV, inclusive, Defendants. Case No. 973505.

Filed: Mar. 24, 1970.

COME NOW the plaintiffs, AMERICAN FIDELITY FIRE INSURANCE COMPANY, a New York corporation, on behalf of itself and all others similarly situated, for a FIRST CAUSE OF ACTION complains and alleges as follows:

I

The true names and capacities whether individual, corporate, associate, a state board or commission, the president, chairman, secretary, or other head or officer of said state board or commission, or otherwise, of defendants, DOES I through XXV, inclusive, are unknown to plaintiffs, who therefore sue said defendants by such fictitious names. Plaintiffs will ask leave of Court to amend this complaint to show their true names and capacities when the same have been ascertained.

II

This Cause of Action is one of common and general interest to all insurance companies duly licensed to do business and doing business in the State of California of writing surety bonds pursuant to the herein-

after mentioned sections of the Revenue and Taxation Code of the State of California. Such other insurance companies comprise a class so numerous that it is impractical for all to appear before this Court as individual plaintiffs; therefore, plaintiffs, AMERICAN FIDELITY FIRE INSURANCE COMPANY, brings suit for itself and on behalf of and for the benefit of all of said members of said class.

III

Plaintiff, AMERICAN FIDELITY FIRE INSURANCE COMPANY, is a New York corporation, duly licensed to do and is doing insurance business in the State of California. Said plaintiff does and has been writing surety bonds for numerous principals, pursuant to, but not limited to Division 2, Sections 6701, 7453, 7454 and 32102, of the Revenue and Taxation Code. Said plaintiff is also making this claim on behalf of all other insurance companies duly licensed to do business in California and which are similarly situated in that they, too, have been writing surety bonds for numerous principals pursuant to the aforementioned Sections of the Revenue and Taxation Code.

IV

In addition to paying principal amounts due plus interest pursuant to writing said surety bonds, plaintiff, AMERICAN FIDELITY FIRE INSURANCE COMPANY, and all others similarly situated, have been paying all penalties due pursuant to Sections 6484, 6485, 6511, 6514, 6537, 6565, 6591, 7654, 7655, 7660, 7662, 7672, 7673, 7705, 7713, 7727, 7879, 8780, 8801, 8804, 8854, 8876, 32252, 32271, 32291, 32292, and 32311 of the Revenue and Taxation Code.

V

Plaintiffs AMERICAN FIDELITY FIRE INSURANCE COMPANY, and all others similarly situated, herein allege that those Sections of the Revenue and Taxation Code hereinabove mentioned in paragraphs II and III of this First Cause of Action are contrary to the intent of the Constitution of the United States and of the Constitution of the State of California, and thus must be deemed to be unconstitutional, or that said Sections of the Revenue and Taxation Code are being applied to said plaintiffs in an unconstitutional manner, specifically:

A. 1. Defendants, and each of them, require and demand that said plaintiffs pay all penalties of their numerous principals pursuant to said surety bonds without notice to said plaintiffs of default by their principals.

2. Plaintiffs admit their obligation to pay all amounts, interest and costs and have been paying all penalties due from their principals, but assert that the liability, if any, to pay the penalties can arise only after proper demand and notice and further that this is the intent of California Civil Code Section 2808 which states: ". . . where one assumes liability, as surety upon conditional obligation, his liability is commensurate with that of the principal and he is not entitled to notice of the default of the principal unless he is unable by the exercise of reasonable diligence to acquire information of such default and the creditor has actual notice thereof."

3. Because of the numerous principals for whom said plaintiffs write said surety bonds, said plaintiffs are unable, by the exercise of reasonable diligence, to

acquire information of any defaults by their numerous principals.

4. To deprive said plaintiffs of notice, and therefore an opportunity to be heard or to cure before requiring payment of penalties, is to deprive said plaintiffs of due process of law in violation of the Fourteenth Amendment of the Constitution of the United States and Article 1, Section 1, and Article 1, Section 13, of the Constitution of the State of California.

B. 1. The Tenth Amendment of the Constitution of the United States creates in the States that which has been commonly referred to as the "police power," a term incorporated by the State of California (see California State Constitution, Article 12, Section 8).

2. This "police power" is inherent in the Constitution of the State of California, particularly Article 1, Section 2, which defines the purpose of government, and Article 4, the legislative department.

3. In no Section of the Constitution of the State of California is there a provision which enables the State of California to delegate its "police power" to private persons or corporations. In fact, Article 12, Section 8, prohibits a corporation from infringing upon the rights and well-being of the State.

4. Therefore, placing the responsibility of penalties upon said plaintiffs is improperly and unconstitutionally delegating to said plaintiffs a duty, penal in nature, which rightfully belongs to the State of California under its "police power."

VI

Plaintiffs are informed and believe, that the amount of money in penalties collected by defendants, and each of them, from said plaintiffs, and others similarly situated, in violation of the aforementioned Sections of the United States and California State Constitutions exceeds the amount of Ten Thousand Dollars ($10,000.00), the exact amount is, at this time, unascertained by said plaintiffs; and said plaintiffs request a refund equal to the amount of all penalties paid to defendants, and each of them, over the past four years.

VII

Plaintiffs are informed and believe that the exact amount of money paid in penalties pursuant to said surety bonds over the past four years will be best ascertainable by an accounting between the parties.

APPENDIX G.

In the Court of Appeal, State of California, Second Appellate District.

American Fidelity Fire Insurance Company, a New York corporation, on behalf of itself and all others similarly situated, Plaintiffs, Cross-Defendants and Appellants, vs. State Board of Equalization of the State of California, Defendant, Cross-Complainant and Respondent. No. 2d Civ. 40797.

Appeal from the Superior Court, Los Angeles County. Honorable Robert W. Kenny, Judge.

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In the Court of Appeal of the State of California, Second Appellate District.

American Fidelity Fire Insurance Company, Plaintiff, Cross-Defendant, and Appellant, v. State Board of Equalization, Defendant, Cross-Complainant, and Respondent. 2d Civ. 40797.

Appeal from the Superior Court of Los Angeles County. Honorable Robert W. Kenny, Judge.

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APPENDIX I.

Petition for Hearing in the Supreme Court State of California.

In the Court of Appeal, State of California.

American Fidelity Fire Insurance Company, a New York corporation, on behalf of itself and all others similarly situated, Plaintiffs, Cross-Defendants, Appellants, and Petitioner, v. State Board of Equalization of the State of California, Defendant, Cross-Complainant, and Respondent. 2nd Civil No. 40797.

TO: DONALD R. WRIGHT, CHIEF JUSTICE OF THE SUPREME COURT OF THE STATE OF CALIFORNIA, AND TO THE ASSOCIATE JUSTICES OF THE SUPREME COURT OF THE STATE OF CALIFORNIA:

Petitioner was appellant in the above-entitled appeal before the Court of Appeal of the State of California, Second Appellate District, Division 4, Case No. 2d Civ. No. 40797. The Court of Appeal rendered and entered a decision on August 27, 1973, and said opinion has been certified for publication. A copy of said opinion is attached hereto and is labeled Exhibit "A" and is made a part hereof by this reference.

Petitioner herein alleges that the decision of the Court of Appeal failed to address, failed to examine, and failed to clearly resolve, at the Appellate level, the constitutional due process issues as properly raised by petitioner in both the trial and appellate courts below.

SUPREME COURT, U. S.

FILED

MAR 5 1974

IN THE

Supreme Court of the United States

October Term, 1973
No. 73-1137

AMERICAN FIDELITY FIRE INSURANCE COMPANY, a New York corporation,

Petitioner,

vs.

STATE BOARD OF EQUALIZATION OF THE STATE OF CALIFORNIA,

Respondent.

RESPONDENT'S OPPOSING BRIEF

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IN THE

Supreme Court of the United States

October Term, 1973
No. 73-1137

AMERICAN FIDELITY FIRE INSURANCE COMPANY, a New York corporation,

Petitioner,

vs.

STATE BOARD OF EQUALIZATION OF THE STATE OF CALIFORNIA,

Respondent.

RESPONDENT'S OPPOSING BRIEF

The petitioner has petitioned this Honorable Court for a Writ of Certiorari to the California Court of Appeals, after decision in that court (*American Fidelity Fire Insurance Company v. State Board of Equalization,* 34 Cal. App. 3d 51 (1973)). The only issue of constitutional law presented in the appeal in California was that of due process under the federal constitution in the imposition of liability for penalties along with the tax and interest against sureties of delinquent sales taxpayers. Each of the particular assertions of unconstitutionality of the sales and use tax law and its administration was answered by the decision of the Court of Appeal in holding that no notice to the surety is required in order to impose liability for tax, interest and penalties. The District Court of Appeal held that petitioner's theories of unconstitutionality were without

merit. It is respectfully submitted that the opinion of the Court of Appeal correctly disposes of the constitutional issues involved in this case so that there is no necessity for a writ of certiorari to the United States Supreme Court. There is absolutely no inconsistency between the opinion of the Court of Appeal and any other decision of California or the United States.

Questions as Presented by Petitioner

1. Whether Amendments V and XIV of the Constitution of the United States require that a state, prior to assessing tax penalties, against the taxpayer's surety for the default of the taxpayer, must give notice to the surety of the amount due before assessing additional sums in the form of penalties against the taxpayer's surety.

2. Whether the assessment of tax penalties against the taxpayer may be imputed to the surety absent notice of the impending default of the principal to the surety.

ARGUMENT

CALIFORNIA TAX COLLECTION PRACTICES AND PROCEDURES COMPLY WITH MODERN FEDERAL DOCTRINES WHICH CONSTRUE THE REQUIREMENTS OF DUE PROCESS

A. Petitioner Erroneously Sets Forth the Tax Collection Procedures of the Board of Equalization of the State of California in Presenting Its Question to This Honorable Court

Petitioner is correct when it states that when the Board of Equalization determines that the taxpayer owes additional taxes a determination thereof is sent to the taxpayer and that the determination becomes final after 30 days unless the taxpayer formally contests the determination. However, petitioner errs when it states that all statutory penalties which are the subject of these proceedings accrue at that time. Petitioner also errs when it states that if the taxes and interest set forth in the determination were timely paid, the penalty provisions would be inapplicable. This language erroneously implies that all the penalties involved under the Sales and Use Tax Law in the State of California accrue at the end of the 30-day period following the notice of determination sent to the taxpayer. This is incorrect.

The notice of determination sent to a taxpayer, in almost all instances after an audit of the taxpayer's books and records has been completed, indicates that a 10% penalty will be due if the amount of the determination is not paid within a thirty-day period as provided by the law. That penalty attaches or accrues or is incurred at the end of the period by reason of the failure to pay the determination. However, other

penalties that may be included in the amount of the determination, such as for failure to file returns or for negligence or for fraud have previously attached or accrued or been incurred by reason of prior acts or failure to act on the part of the taxpayer. Also, if a return in the proper amount is paid late, a penalty will have attached or accrued or been incurred at the time the tax was due and no determination would be issued at all. In all of these cases the penalty accrues before the board has any reason to assume it will accrue. It would not be reasonable to require the Board to send notice to the surety in advance of each time that a penalty might be incurred depending upon actions that may or may not be taken by the taxpayer. That would require notice to the surety each time a determination is issued and prior to the end of each reporting period, quarterly or monthly or annually for which a tax must be paid.

Hence, under the law of California, the only penalty that could possibly be avoided by payment within the thirty-day period following a notice of determination is the ten percent penalty under section 6565 of the Revenue and Taxation Code for failure to pay the amount of the determination by the end of the period. Again, this is only in the rare instance when a taxpayer has been audited, not in the normal case where a return has been filed and the taxpayer has failed to pay. Such payment would not avoid any penalties included in the amount of the determination, such as those for failure to file, negligence or fraud. These latter penalties are the ones for the most part which American Fidelity sought in its refund action and refused to pay so as to require the counter-suit by the Board. The petition merely sets forth arguments directed toward the

failure to pay a determination penalty under section 6565. None of the arguments set forth in the petition would apply to the penalties incurred for failure to file returns, negligence or fraud, or failure to pay prior to a determination. In general, the surety argues it should have notice that the taxpayer has failed to pay his taxes and is about to be charged with a penalty. But all of the penalties are incurred by some act or omission on the part of the taxpayer which the Board cannot foresee and they are not curable by payment after they are incurred. A notice of determination, when issued, is essentially notice to the taxpayer that the Board has found that the penalties along with the tax and interest have been incurred.

Even in the instance where a deficiency determination has been sent to the taxpayer, there is no reason to assume a taxpayer will fail to pay a deficiency inasmuch as the taxpayer has known of the audit and is probably well aware of the fact that additional tax will be owed. It would be unduly burdensome for the Board to require it to notify sureties that the taxpayer owed more tax than was stated on his return. It would also be inappropriate.

B. Section 6701 of the Revenue and Taxation Code Is Constitutional

American Fidelity admitted that it had the obligation under section 6701 of the Revenue and Taxation Code and its contract to pay all amounts including penalties due on the bonds, however, American Fidelity claimed that the obligation to pay penalties is unconstitutional under the Fourteenth Amendment of the United States Constitution, unless there is proper demand and notice of the default of the principal under

the provisions of section 2808 of the California Civil Code. (App. Op. Br. pp. 27-38.) On the contrary, the surety obligation under section 6701 of the Revenue and Taxation Code is no different than an ordinary surety liability which never requires notice of default on an unconditional bond.

Penalties are incurred immediately on the failure to make timely payments or returns and if due to fraud the penalties are more severe. There may be relief from some penalties for reasonable cause, however, when incurred the penalty becomes a part of the tax. Thus, there are no separate surety law requirements of the tax, interest and penalty. The security bonds in this case in compliance with section 6701 are absolute and unconditional obligations. Under section 2807 of the California Civil Code the surety is liable to the creditor immediately upon the default of the principal, and without demand or notice. Section 2808 is inapplicable to the state because that section applies only to conditional obligations and furthermore the state cannot be held to notice unless the statute upon which the bond is based specifically provides for notice. The statute becomes a part of the bond.

Notice of default would serve no useful purpose because the state has no more knowledge than the surety at the time the penalty is incurred and notice of default would permit no protective, remedial action by the surety. Immediate notice of default would constitute a burden upon the state without any benefit to the surety. The state as a matter of practice provides sufficient notice of default when the demand is made. American Fidelity has not shown any treatment by the state which differs from the treatment that the law

provides for all sureties by creditors and thus any claim of unconstitutionality fails for lack of factual support.

Similarly, American Fidelity's claim that section 6701 constitutes the improper delegation of a state's duty which is penal in nature is without factual support. There is no delegation of duty but rather the collection of a tax including the penalty which is not a state penal function.

1. Penalties Are Part of the Tax and Cannot Be Segregated for Different Treatment Under the Law

It is well settled in California that a penalty which is created by statute for failure to pay tax assessment becomes part of the tax. *Sonleitner v. Superior Court*, 158 Cal. App. 2d 258 (1958) (and cases cited therein).

Penalties in exact percentages are provided for late prepayment (sections 6476, 6477, 6478), late payments (section 6591), negligent and fraudulent deficiencies of payments (sections 6484 and 6485), and failure and fraudulent failure to file a return (sections 6511 and 6514). There is no discretion in the amount of a penalty. If the board finds that a person's failure to make a timely return or payment is due to reasonable cause and circumstances beyond the person's control and occurred notwithstanding the exercise of ordinary care and the absence of wilful neglect, the person may be relieved of the penalty provided by sections 6476, 6477, 6511, and 6591 (section 6592). Provision is made for notice and hearing (sections 6561-6566). The regulations in regard to penalties are found in Regulation 1703, 18 California Administrative Code, section 1703.

As can be readily seen from these provisions, penalties are incurred immediately on the failure to make timely or adequate payment or file returns, and notice of default immediately thereafter would carry no advantage to the surety on the bond provided pursuant to section 6701. Notice of default would serve no useful purpose because the state has no more knowledge than the surety at the time that penalties are incurred and default cannot be anticipated. Immediate notice of default would constitute an undue burden upon the state without any benefit to the surety.

2. Demand and Notice of Default Are Not Required for the Bonds Under Section 6701

A suretyship obligation may be either absolute or conditional. An absolute guarantee is an unqualified undertaking that if the debtor fails in performance the guarantor will perform, whereas a conditional guarantee contemplates, before the guarantor is liable on the contract, the happening of some contingency such as exhaustion of remedies against the principal debtor, exhaustion of other security, procurement of a particular fund, immediate suit on default of the debtor, *demand and notice,* or an accounting. 46 Cal.Jur.2d, § 13, pages 204-05. A suretyship obligation is to be deemed unconditional unless its terms impart some condition precedent to the liability of the surety. Civ. Code § 2806; *Standard Oil Co. v. Houser,* 101 Cal. App. 2d 480, 487 (1950).

The general rule is that the liability of a surety (in the absence of a different contractual provision) accrues at the same time as that of the principal or upon default of the principal. A surety who has assumed liability for payment or performance is liable to the

creditor immediately upon the default of the principal and without demand or notice. *Bloom v. Bender,* 48 Cal. 2d 793, 799 (1957) (citing Civ. Code § 2807; *Somers v. United States F. & G. Co.,* 191 Cal. 542, 546 (1923).) In the latter case the bond language was analogous to the bonds in the instant case.

When an instrument signed by the guarantor is not a conditional or qualified guaranty, the guarantor's argument to that effect and citations relating to such a guaranty are not pertinent. *Standard Oil Co. v. Houser, supra,* 101 Cal. App. 2d 480, 489 (1950).

The state is a special entity not to be bound by notice restrictions unless such a legislative intent clearly appears. *State of California ex rel. Dept. of Employment v. General Ins. Co.,* 13 Cal. App. 3d 853, 858, 861 (1970). The terms of a statute dealing with official bonds fixing the obligation of the surety within the penal sums specified are read into the bond and become a part of it. *Hartford Acc. Etc. Co. v. City of Tulare,* 30 Cal. 2d 832, 837 (1947). Section 6701 does not provide for notice of any kind by the State Board of Equalization prior to an action on the security.

The State Board of Equalization in the instant case has made demand upon surety American Fidelity in each instance wherein the taxpayer has failed to fulfill his obligations to the Board. This demand for payment is sufficient notice of default. The Board cannot give more timely notice because the Board has no notice itself of circumstances which would justify a penalty until after payments or prepayments are delinquent or quarterly returns have been filed or where the taxpayer has failed to file such a return.

American Fidelity appears to suggest that notice is required at the moment the tax is due to give the surety

an opportunity to avoid the penalty by itself paying the tax. The suggestion is unsound. Even if it were possible, which it is not, it would be an unreasonable burden on the Board. It is unreasonable to ask the Board to somehow anticipate default by late return, late payment, negligence or fraud. In all such cases the Legislature would have been influenced by the hardship on the state of immediate notice of default and the utter futility of such notice as a condition precedent to liability on a bond. *See State of California ex rel. Dept. of Employment v. General Ins. Co., supra,* 13 Cal. App. 3d 853, 861-62 (1970). American Fidelity has therefore not shown any treatment by the state which is unfair or which differs from the treatment that the law provides for all sureties by creditors and thus any claim of unconstitutionality fails for lack of factual support.

Provision is made for notice and hearing on determinations of tax and penalties in order to allow the taxpayer to establish that the amounts are not due under the provisions of the Sales and Use Tax Law (sections 6561-66). These sections do not require notice to the surety. Section 6592 provides that relief from penalty is allowed if the board finds that a person's failure to make a timely return or payment is due to reasonable cause and circumstances beyond a person's control and occurred notwithstanding the exercise of ordinary care and the absence of wilful neglect. This section gives the taxpayer the opportunity to file a statement under penalty of perjury setting forth the facts upon which the taxpayer bases his claim for relief.

Under said circumstances, the taxpayer has received a hearing after notice of the determination.

Due process, as it has evolved with respect to taxes, has been described in the following terms:

> "It may be stated as a general rule that the due process clause of the federal Constitution is satisfied in matters of taxation if, at some stage before a tax becomes irrevocably fixed the *taxpayer* is given the right, of which he shall have notice, to contest the validity or amount of the tax before a board or tribunal provided for that purpose. [Citations.]" *People v. Sonleitner,* 185 Cal. App. 2d 350, 356. Italics added.

It has been held that notice and hearing to the taxpayer is not constitutionally compelled when the tax is self-assessed, as are income and sales taxes. *Greene v. Franchise Tax Board,* 27 Cal. App. 3d 38, 43. *Greene* relied upon *Randall v. Franchise Tax Board of State of California,* 453 F. 2d 381, 382 (9th Cir. 1971) wherein it was held:

> "We do not think Sniadach v. Family Finance Corp., 1969, 395 U.S. 337, 89 S. Ct. 1820, 23 L.Ed.2d 349, upon which appellant relies, requires a different result. That case dealt with prejudgment wage garnishment, levied without any notice to the debtor. The procedure here is more like postjudgment execution. Appellant had assessed his own liability and has never claimed that he does not owe the tax. Moreover, he was twice notified of his delinquency and never responded to either notice."

Randall in turn relied upon *Aronoff v. Franchise Tax Board of State of California*, 348 F. 2d 9, 11 (9th Cir. 1965) wherein it was held:

> "It has consistently been held, without a single instance of deviation, that the refund action provided by California Personal Income Tax Law is a 'plain, speedy and efficient remedy' such as to invoke the restraints of 28 U.S.C. § 1341. The Supreme Court opinion in Matthews v. Rogers, 284 U.S. 521, 52 S.Ct. 217, 76 L.Ed. 447 (1932), was the first of a long series of cases to illumine the need, implicitly recognized in § 1341, for state independence in state fiscal matters."

Plaintiff undertakes, for a consideration which is a substantial percentage of the bond, to guarantee the payments due the state. In each case included in the factual stipulation, the amount of the bond written exceeded the total liability incurred by the taxpayer, including principal, interest and penalties. Thus, lack of notice did not result in the surety being required to pay more than it had originally obligated itself to pay. We submit that there is no constitutional compulsion for the Board to give duplicate notice to the surety; its obligation is fulfilled by notice to the taxpayer of the delinquency.

3. There Is No Violation of Due Process or Equal Protection in Requiring Surety for Penalties

American Fidelity contends at pages 11 to 12 that the transfer of the penalties for late payment from the principal to the surety is an arbitrary misuse of the state's police power. It contends at pages 12 and 15 to 22 that the penalties are intended to punish delinquent behavior, that the procedure which imposes liability for penalties upon the surety is contrary to any reason-

able legislative purpose, and that the transfer of penalties deprives the surety companies of fundamental due process protections provided by the United States Constitution against arbitrary state punishment. These contentions were not pleaded in the complaint, nor were these questions among any of the issues set forth in the statement of issues, contentions, and itemization of damages which was incorporated in the pretrial conference order.

There having been no facts alleged in the complaint to support these claims and no mention of these issues in the pretrial conference order, the trial court had no such issues properly before it. *City of Los Angeles v. County of Mono,* 51 Cal. 2d 843, 847 (1959); *Thompson v. Guyer-Hays,* 207 Cal. App. 2d 366, 372 (1962).

In any event, penalties are reasonably imposed under the Revenue and Taxation Code for delinquency and become a part of the tax. *Sonleitner v. Superior Court, supra,* 158 Cal. App. 2d 258 (1958). It is not improper for the State of California to obtain security for the payment of its taxes lawfully imposed. Surety bonds as a form of security based upon liability for delinquent behavior and including penalties are valid.

American Fidelity has cited absolutely no authority that the exaction of penalties for delinquency on tax obligations is the imposition of punishment for a crime, or that a state may not require security against the payment of penalties imposed for delinquency which become a part of the tax itself. It is merely a bald assertion. In the absence of authority to the contrary, it would seem reasonable that the legislation authorizing security is constitutional in order to maintain the fiscal integrity of the state.

Legislative enactments dealing with economic problems usually involve complex, technical and practical considerations which the legislative process is designed to resolve. Therefore, in order for the Legislature to function properly, the courts have given the Legislature considerable latitude in setting up classifications dealing with taxes and economic problems. Legislative determinations of these areas should be conclusive upon the courts unless totally without justification. *Ferguson v. Skrupa*, 372 U.S. 726, 732 (1963); *Railway Express v. New York*, 336 U.S. 106 (1949); *West Coast Hotel Co. v. Parrish*, 300 U.S. 379, 398 (1937); *Lindsley v. Natural Carbonic Gas Co.*, 220 U.S. 61, 78 (1911).

Classifications are valid if they have some reasonable basis. Nor is a classification unreasonable because it results in some inequity. *Dandridge v. Williams*, 397 U.S. 471, 485 (1970). Under both United States and California law classification is permitted. Only if a classification is plainly arbitrary will it be set aside, otherwise it will be presumed valid. If any state of facts supports the classification, Equal Protection is served. *Associated Home Builders etc., Inc. v. City of Newark*, 18 Cal. App. 3d 107, 109 (1971); *Zuckerman-Mandeville, Inc. v. Sheffield*, 8 Cal. App. 3d 793, 799 (1970); *Romero v. Hodgson*, 319 F. Supp. 1201 (1970), *aff'd* 403 U.S. 901 (1971).

The leading case here is *Carmichael v. Southern Coal Co.*, 301 U.S. 495 (1937), which upheld the classifications created by State Unemployment Com-

pensation statutes which conformed with the federal plan. In *Carmichael,* the United States Supreme Court stated on pages 509-10:

> "It is inherent in the exercise of the power to tax that a state be free to select the subjects of taxation and to grant exemptions. Neither due process nor equal protection imposes upon a state any rigid rule of equality of taxation. [Citations.] This Court has repeatedly held that inequalities which result from a singling out of one particular class for taxation or exemption, infringe no constitutional limitation. [Citations.]
>
> "Like considerations govern exemptions from the operation of a tax imposed on the members of a class. A legislature is not bound to tax every member of a class or none. It may make distinctions of degree having a rational basis, and when subjected to judicial scrutiny they must be presumed to rest on that basis if there is any conceivable state of facts which would support it. [Citations.]
>
> "This restriction upon the judicial function, in passing on the constitutionality of statutes, is not artificial or irrational. A state legislature, in the enactment of laws, has the widest possible latitude within the limits of the Constitution. In the nature of the case it cannot record a complete catalog of the considerations which move its members to enact laws. In the absence of such a record courts cannot assume that its action is capricious, or that, with its informed acquaintance with local conditions to which the legislation is to be applied, it was not aware of facts which afford reasonable basis for its action. Only by faith-

ful adherence to this guiding principle of judicial review of legislation is it possible to preserve to the legislative branch its rightful independence and its ability to function."

Many cases since *Carmichael* have reaffirmed the standard applied in *Carmichael* in situations involving economic issues. We submit that under the case of *Dandridge v. Williams, supra,* 397 U.S. 471, 485 (1970), the constitutionality of the bonding statutes of the Revenue and Taxation Code is to be tested by the "reasonable basis" rule traditionally applied to economic and social legislation. *Lindsley v. Natural Carbonic Gas Co., supra,* 220 U.S. 61, 78 (1911), rather than the "compelling interest" test recently applied in *Shapiro v. Thompson,* 394 U.S. 618 (1969), to strike down state welfare residency requirements.

Under the reasonable basis test as applied in *Carmichael* and recently affirmed in *Dandridge,* as well as our California cases cited above, the parties attacking the statutory classification have the burden of showing that the challenged classification does not rest upon any reasonable basis, but is essentially arbitrary. As shown in the cases cited, *supra,* the possible, rational bases which respondents must show to be lacking as to the requirement that the bond cover penalties are not just those that were actually considered by the legislature at the time of enactment, but also any such rational basis which may be conceived to support the classification. *Dandridge v. Williams, supra,* 397 U.S. 485 (1970); *Allied Stores of Ohio v. Bowers,* 358 U.S. 528 (1959); *Carmichael v. Southern Coal Co., supra,* 301 U.S. 509 (1937); *Lindsley v. Natural Carbonic Gas Co., supra,* 220 U.S. 78 (1911). As was

said in *Flemming v. Nestor*, 363 U.S. 603, 612 (1960), "For these purposes, it is, of course, constitutionally irrelevant whether this reasoning in fact underlay the legislative decisions, . . ."

American Fidelity has failed to satisfy the admittedly and justifiably high standard of proof which is required of those who would have this court invalidate legislation passed by the elected legislature.

It was within the power of the legislature so as to insure the efficient collection of sales and use tax to provide that retailers be required to post security for tax, interest *and penalties* in order to encourage compliance with the law and protect the revenue sources of the State of California. American Fidelity erroneously asserts that the State Board of Equalization rather than the legislature requires a bond for penalties. (App. Op. Br. p. 18.) Section 6701 clearly provides for security to recover tax, interest *and penalty*. If surety companies wish to engage in the business of providing the necessary security, they cannot complain of coming within the classification of a surety of sales and use taxes including tax, interest and penalties. It must be remembered that the administrative convenience of collecting sales and use tax through the security statutes is a justifiable reason for these statutes. *Carmichael v. Southern Coal Co., supra,* 301 U.S. 495, 511 (1937), is a case in point where it was held:

> "Administrative convenience and expense in the collection or measurement of the tax are alone a sufficient justification for the difference between the treatment of small incomes or small taxpayers and that meted out to others. [Citations.] We cannot say that the expense and inconvenience of collecting the tax from small employers would not be disproportionate to the revenue obtained. . . ."

In the earlier case of *Burnet v. Wells,* 289 U.S. 670, 678 (1933), the court said:

> ". . . Even administrative convenience, the practical necessities of an efficient system of taxation, will have heed and recognition within reasonable limits. . . ."

In the recent case *Schilb v. Kuebel,* 404 U.S. 357, 369 (1971), it was recognized that administrative convenience can form a reasonable basis for a classification.

Conclusion

This concludes the response to the petition in the instant case. Respondent believes that when the record is examined relative to the matter claimed of, and the opinion of the California Court of Appeal considered, it will be concluded by this Honorable Court that no right guaranteed by the Constitution of the United States was violated, and that the judgment should stand. Accordingly, respondent submits the matter on the record heretofore presented to this Court, the opinion of the California Court of Appeal and the arguments set forth above, and requests that the relief asked by this petitioner be denied.

Respectfully submitted,

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